An Analysis of Capital Structure of Firms and Anomalies that Persist in the Sri Lankan Context: An Empirical Study of Selected Firms Listed on the Colombo Stock Exchange

Y. Jayasekara[1] & D. A. I. Dayaratne[2]

PhD Student, Faculty of Graduate Studies, University of Colombo.[1]
Department of Accountancy & Finance, Sabaragamuwa University of Sri Lanka.[2]
yaveenj@gmail.com[1] , indunildaya@gmail.com[2]

This paper attempts to analyze the compositions of the capital structures of the 40 firms listed on the CSE. Moreover, it aims to assess the relationship between the Debt to Equity (D/E) ratio and the market capitalization (firm value) of the selected firms. Further, key financial indicators such as short term interest bearing borrowings, long term interest bearing borrowings and share-holders funds have been considered. The information related to short term interest bearing borrowings, long term interest bearing borrowings and share-holders funds are also obtained. Minority interest is disregarded to prevent inaccurate results. For the purpose of the analysis the firms are categorized into low geared (<0.35), moderately geared (0.36 – 0.55) and high geared (> 0.56). The study does not take into account firms in the Financial Sector. The reason for their exclusion is the existence of a different set of determinants that impact the leverage decision due to their different business model and cyclical factor that skews the data sample. The analysis reveals a mean D/E ratio of 0.39-0.44 across all industries which may indicate mean reverting tendencies to firms, which lending institutions and investment banks could capitalize on, in order to identify potential issuers of debt or equity. In addition, analysis has clearly established that short term debt is the most preferred form of finance with a mean leverage of 0.21 and a standard deviation of 0.13 whereas long term debt indicated a mean of 0.16 and a standard deviation of 0.19. Firms that had foreign ownership too indicated low levels of gearing with the mean leverage amounting to 0.11. Whilst appreciating the varying leverage compositions in firms across varying industries the study demonstrates that the theory may not hold true under specific instances for firms listed on the CSE. Finally results further reveal that overall gearing levels is one of the variables that influence firm value and that additional variables such as revenue, profitability, taxes

etc. should be factored in as an area of further study to assess the impact on overall firm value.

Keywords: Capital Structures; D/E Ratio; Firm Value